

# INTEREST RATE RISK EXPOSURE ASSESSMENT - PAGE 6

## IMPACT ON COMPONENT RATINGS

Assessment of the institution's vulnerability to changes in interest rates and management's ability to handle the sensitivity to interest rates should be reflected primarily in the Earnings component. Also consider the assessment when assigning the component ratings to Management, Liquidity, and Capital.

## COMMENTS

Focus comments on financial analysis of the institution's exposure to interest rate risk. Generally, it is more appropriate to assess and criticize policies relating to interest rate risk on the Administration, Supervision, and Control page (Item #3). Present comments which support assumptions made in constructing the Interest Rate Risk Exposure Measurement schedule in the Assumptions section of that page.

Detail material conclusions and comments pertaining to interest rate risk here; summarize them on the Examination Conclusions and Comments page.

## SUPPLEMENTAL PAGES

Include supplemental pages, as needed, to support core page comments. Use of additional schedules and/or measurements is encouraged when such information contributes to the assessment of interest rate risk exposure.

## DURATION ANALYSIS

Duration is recognized as an alternative means of measuring interest rate risk. If the institution uses duration analysis, include an assessment of that analysis.

# INTEREST RATE RISK EXPOSURE MEASUREMENT - PAGE 6

## TIME HORIZONS

The four column headings are left blank to allow for selection of any combination of time horizons. Amounts in time horizons subsequent to the shortest horizon selected should be cumulative.

Choose the time horizons which provide the most meaningful information regarding the institution's exposure to interest rate risk. While in some unusual cases, an "immediately repricable," "3-month," or other short-term time horizon may be appropriate, the shortest time horizon used should generally be a "6-month" horizon. The cumulative total of the longest time horizon column should include at least 75% of the institution's total assets in the case of an asset-sensitive institution, or at least 75% of the institution's total liabilities in the case of a liability-sensitive institution.

Generally, it is not useful to include a time horizon such as "over five years" which captures all rate-sensitive assets (RSA) and rate sensitive liabilities (RSL) not captured in the previous time horizon.

*Note:* In some cases, examiners may want to use columns to schedule information from prior examinations.

## CALL REPORT DATA

Interest rate risk information requested in the Call Reports for adjustable-rate assets is based on repricing frequency rather than next repricing opportunity. For Call Report purposes, a one-year, variable-rate loan that will be repricing in the next 30 days is shown in the twelve-month time horizon (not a shorter time horizon). Many institutions have repricing opportunity information available. Use whichever information is most appropriate for the institution being examined. If material, note methodology in the assumptions section.

## ASSUMPTIONS

Examiners must make several important assumptions when constructing this schedule. In large part, these assumptions will determine the results of the analysis. As such, it is essential to carefully consider the rate-sensitivity characteristics of each group of earning assets and funding liabilities. State and fully support assumptions. For example, if 50% of the institution's regular savings deposits are shown as rate-sensitive liabilities (and this assumption has a significant impact on the resulting ratios), fully support the reasons behind this assumption.

## USE OF THE INSTITUTION'S RATE-SENSITIVITY ANALYSIS

When the institution performs an accurate rate-sensitivity analysis and fully supports assumptions, examiners may use any or all of the institution's figures. Footnote any use of the institution's internal analysis and supporting assumptions.

# INTEREST RATE RISK EXPOSURE MEASUREMENT - PAGE 6 (continued)

## FACTORS TO CONSIDER IN CONSTRUCTING THE RSA/RSL SCHEDULE

### Rate-Sensitive Loan and Lease Breakdowns

In general, the following apply:

- Fixed Rate by Maturity - Include principal balances of all fixed-rate loans which have contractual maturity dates within the applicable time horizon.
- Floating Rate by Repricing Interval - Include principal balances of all floating-rate loans repricing within the applicable time horizon.
- Scheduled Payments on All Other Loans - Include in each time horizon all contractually scheduled principal payments on fixed-rate loans maturing and floating-rate loans repricing after that time horizon. This treatment would necessitate adjusting the two previous categories subsequent to the first horizon to preclude double-counting. Since these complex adjustments would rarely be material, Scheduled Payments on All Other Loans generally should include contractually scheduled principal payments on fixed-rate loans maturing and floating-rate loans repricing beyond the longest time horizon used. Normally, this treatment will result in a slight understatement of RSA in the early time horizons (due to the fact that scheduled payments on fixed-rate loans which mature and floating-rate loans which reprice within the longest time horizon are not accounted for in the schedule.) Since virtually all floating-rate loans will be covered above, in effect, this category will consist of scheduled payments on amortizing fixed-rate loans which have final maturity dates beyond the longest time horizon used.

Nonaccrual Loans and Securities - Exclude these assets.

Loan prepayments - Prepayments on fixed and variable-rate loans may have a significant impact on rate-sensitivity analysis. This problem is most apparent when comparing contractually scheduled principal payments on long-term, fixed-rate loans (for example, 30-year mortgage loans) with actual or estimated principal payments on those loans. Where material, take into account the impact of projected prepayments on loans maturing or repricing in longer-term horizons and include a "Loan Prepayments" line item in "Other" RSA.

"Other" Rate-Sensitive Assets - The "Other" category under "Assets" may include such items as stripped mortgage-backed securities and residuals or trading account activities that the institution may use for managing its interest rate risk. For example, it would be more appropriate to include such nontraditional investments as interest-only strips (IOs) and principal-only strips (POs) in this category rather than in the "Securities" category. The Securities Section of the Manual discusses many of these nontraditional investments.

Adjustable-Rate Mortgages - Most adjustable-rate mortgages, as well as many other variable-rate loans, have contractual annual and lifetime limits (caps) on upward interest rate adjustments. Similarly, variable-rate loans may also have lifetime limits (floors) on downward interest rate adjustments. Remember that in some interest rate scenarios, these loans are not fully adjustable and institutions will derive limited or no benefit from rate adjustments. In virtually all cases, a lag or timing difference exists between market interest rate movements and loan repricing.

Mortgage-Backed Securities - Additional principal payments on mortgage-backed securities may differ significantly from contractually scheduled payments for various reasons. Consider all factors when completing this schedule.

Regular Savings Deposits - Generally, deposits such as regular savings and NOW accounts possess characteristics of both rate-sensitive and nonrate-sensitive liabilities. The Assumptions section should support the decision to include or exclude all or any portion of such deposits as rate-sensitive liabilities (when material).

## INTEREST RATE RISK EXPOSURE MEASUREMENT - PAGE 6 (continued)

### FACTORS TO CONSIDER IN CONSTRUCTING THE RSA/RSL SCHEDULE (continued)

Demand Deposits - Changes in market interest rates have a direct impact on the level of noninterest-bearing funds that depositors are willing to maintain. As such, be aware of market interest rate scenarios where there will likely be shifts between noninterest and interest-bearing liabilities. In such scenarios, "decay rate" assumptions may be warranted.

### OFF-BALANCE SHEET ACTIVITIES

Include significant off-balance sheet activities used for hedging purposes. Consider the following off-balance sheet activities when evaluating the overall adequacy of the institution's capital accounts. Additionally, criticize any inappropriate speculative positions or positions which do not adhere to the institution's policy.

Interest Rate Swaps - The interest rate sensitivity analysis should reflect the effect of using swap agreements for hedging purposes. For example, if the effect of the swap is to convert floating-rate liabilities to fixed-rate liabilities, then show the notional amount of the swap as a reduction to rate-sensitive liabilities. On the Interest Rate Risk Exposure Assessment page, discuss any adverse effect the interest rate swap has on the interest rate risk of the institution.

Interest Rate Caps and Floors - The interest rate sensitivity analysis should reflect the effect of using caps or floors for hedging purposes. Purchased caps essentially convert a floating-rate liability to a fixed-rate liability: Show these as a reduction to rate-sensitive liabilities. Purchased floors convert a floating-rate asset to a fixed-rate asset: Show these as a reduction to rate-sensitive assets.

Slot caps and floors on the interest rate exposure schedule in one of two ways:

- (1) The notional amount of the cap or floor can be multiplied by the delta of the cap or floor and the delta-weighted notional amount can be slotted as described.

**OR**

- (2) The strike rate on the cap or floor can be compared to the underlying index. If the index rate is within 100 basis points of the strike rate (or in-the-money), the notional value of the cap or floor is slotted as described above.

On the Interest Rate Risk Exposure Assessment page, discuss any adverse effect cap or floor positions have on the interest rate risk of the institution.

Interest Rate Forward and Future Contracts - The interest rate sensitivity analysis should reflect the effect of using futures for hedging purposes. For example, if the effect of a futures hedge is to lengthen liabilities, then subtract the par value of the futures from rate-sensitive liabilities. On the Interest Rate Risk Exposure Assessment page, discuss any adverse effect futures and forward contracts have on the interest rate risk of the institution.

## INTEREST RATE RISK EXPOSURE MEASUREMENT - PAGE 6 (continued)

### OFF-BALANCE SHEET ACTIVITIES (continued)

Interest Rate Options - The interest rate sensitivity analysis should reflect the effect of using options for hedging purposes. Show purchased calls and written puts as a reduction to rate-sensitive assets. Show purchased puts and written calls as a reduction to rate-sensitive liabilities. Slot options using delta equivalent values. Multiply the notional or par amount of the option contract by the option's current delta, and slot this delta equivalent value as described above. On the Interest Rate Risk Exposure Assessment page, discuss any adverse effect option positions have on the interest rate sensitivity of the institution.

Forward Rate Agreements (FRAs) - The interest rate sensitivity analysis should reflect the effect of using FRAs for hedging purposes. Show purchased FRAs as a reduction to rate-sensitive liabilities. Show sold FRAs as a reduction to rate-sensitive assets. On the Interest Rate Risk Exposure Assessment page, discuss any adverse effect FRA positions have on the interest rate risk of an institution.

*Reference:* Rate Sensitivity Analysis Section of the Manual  
Capital Markets Manual